CHASE

International Finance

Vol. XVII, No. 9
April 26, 1982

Issued biweekly by the Economics Group of The Chase Manhattan Bank for corporate customers and correspondent banks. Managing Editor: Diana J. Rich

B1900-1 4/27/82

The French Franc Under Fire

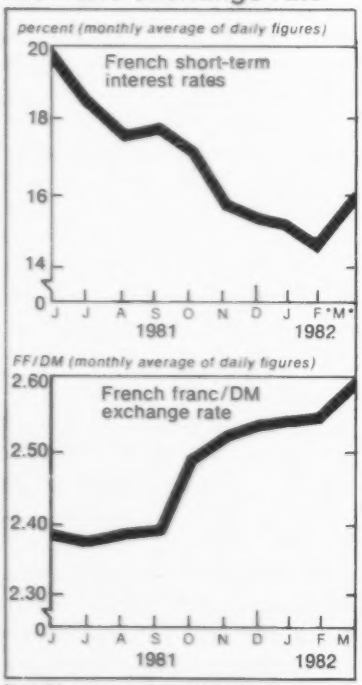
The French franc encountered enormous speculative selling pressure last month, hitting the intervention limits of the European Monetary System (EMS) in terms of both the German mark and the Dutch guilder. Four events appeared instrumental in sparking this latest bout of speculation. First, the February realignment of Belgian franc and Danish kroner parities switched focus onto the French franc as the next likely candidate for devaluation. Second, early budget estimates for 1983 showed an expected doubling of the FF 100 billion deficit likely to be registered this year. Third, France registered a trade deficit of FF 40 billion over September-February—twice the deficit of the prior six-month period. And finally, the swing against the government in the March local elections appears to have encouraged the belief that the Mitterrand administration may step up its reflationary program.

At that time, concerted European central bank intervention helped shore up the currency. The Bank of France itself reacted aggressively, raising its money market intervention rate to 18%—a six-month high. In addition, existing exchange controls were further tightened. Exporters must now repatriate foreign earnings within a 15-day interval, rather than the previously permitted period of one month.

Tighter monetary policy, however, is inconsistent with the expansionary aims of the French government. Moreover, it comes at a time when there is disturbing evidence that the nation's economic recovery is running out of steam: Consumer spending remains sluggish at best, despite increased social transfers. And private investment is still depressed, as firms face a severe financial squeeze in a period of great uncertainty. Foreign demand also remains weak, with the recovery in overseas markets now apparently postponed. These developments all throw doubt on whether France's official target of 3% growth in real GDP can be achieved this year.

If the government is to continue its attempts at reflation, it must break with the financial discipline that current EMS limits impose. It has several possible options. For example, policymakers could choose an early, but small, franc devaluation. This would permit some decline in interest rates but would also run the risk of renewed pressure later on. A more radical alternative might include either a widening of franc intervention bands, similar to those currently in effect for the lira, or the setting up of a two-tier exchange rate system along Belgian lines. Temporarily leaving the EMS altogther is perhaps the least likely option. But whatever path the government chooses, the status quo is unlikely to be maintained past the summer.

French interest rates and the franc exchange rate



*monthly average of weekly figures

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Canadian indicators spell recession.

The Canadian economy is in a distinct slowdown phase. Real growth advanced 3% for 1981 as a whole, but output has actually been falling since the third quarter. Declines have been notable in retail sales, autos, and durable equipment. Business profits fell 26% last year and investment spending is slowing. In March, the unemployment rate topped a 36-year high at 9%. Capital resources are also underemployed, with the industrial operating rate at 75% and inventories rising. The forces behind these various indications of recession include not only the U.S. recession, high interest rates, and persistent inflation expectations, but also the anticipation of further restrictive monetary and fiscal policies designed to produce a slowdown. Thus far, government efforts to bring down inflation have had only marginal success. Price increases through February have averaged 11.6% at an annual rate, compared with a rate of 12.5% at the end of last year. In this environment, the economy is expected to remain flat, at best, and may very well decline in 1982.

Projections of current-account surplus in 1982 help Finland cope with slower economic growth.

Finnish domestic economic activity remains quite strong by international standards. However, the overall pace of growth is slowing and there is rising concern about the prospects for employment over the next year and beyond. Unemployment is expected to exceed 6.5% this year, after rising to 5.3% in 1981 from 4.8% in 1980. The most recent 1982 economic forecast by the finance ministry predicts GNP growth of 1.6%—slightly less than the earlier forecast of 1.8%—and a continuing decline in Finland's export competitiveness, resulting from the country's 10% inflation rate. Nevertheless, the relatively slow rate of economic growth will limit the demand for imports. And as a result, the current account of the balance of payments is expected to show a surplus of 1.6 billion markka this year, compared with a deficit of some fmk. 1.7 billion in 1981. February trade figures—a surplus of some fmk. 685 million juxtaposed with the February 1981 surplus of only fmk. 31 million—indicate the turnaround is already under way.

Difficult policy choice ahead for Greek government if deficit fails to improve.

Greek Prime Minister Papandreou's socialist government unveiled its first budget last month. Despite a 35% increase in state expenditures, the document projects an improved deficit position in 1982—down to 9% of GNP from 12% in 1981. The government anticipates that hikes in indirect and corporate profit taxes, combined with a property tax, higher income taxes for top income earners, and tighter enforcement of tax collections will bolster revenues by some 59%. These revenue projections, however, may prove to be overly optimistic. Few private forecasters expect economic growth in 1982 to be as robust as the 2% the government is hoping for. Moreover, the official budget figures do not take into account the deficits of Greece's public corporations, which last year came to an estimated 3% of GNP. Failure to reduce the budget deficit would leave the authorities with an unpleasant choice between further squeezing the hard-hit private sector or raising credit expansion—a move that bears the threat of boosting the inflation rate well above last year's 25%.

Improvement in Israeli current-account gap expected in 1982.

Provisional estimates indicate that the current account (excluding transfers) of Israel's balance of payments in 1981 registered a deficit of $4.4 billion. While this amounts to a deterioration of some $550 million from the deficit registered in 1980, it is almost entirely explained by a $650 million increase in defense imports associated with the Negev military redeployment. In fact, the "civilian deficit" shrank by $100 million to about $2 billion last year. This represents a creditable performance in view of a further deterioration in the terms of trade. A surge in imports of consumer goods that followed a pre-election cut in purchase taxes was more than offset by a slump in diamond imports and a drawdown of oil stocks. And while the world-wide recession in the diamond industry constrained diamond exports, other industrial exports—led by minerals, metals, and electronics products—rose 17% in volume terms. Official forecasts look for some continuation in these trends over 1982. And with military imports expected to fall, an improvement in the overall current-account balance seems likely.

Chilean adjustment working, but costs are high.

Chile is adjusting to a current-account deficit that had been proving increasingly difficult to finance—by means of a domestic recession. Monthly import expenditures, according to registered intentions to import, have fallen sharply from an average of $600 million in the first ten months of 1981 to $370 million since then. Also, inflation continues to decelerate, supporting projections that by year-end the rise in the CPI will have slowed to about 3%. And, more importantly, wage costs are decreasing. This adjustment, however, is occurring at high social costs. Real GDP is likely to decline 3%-5% this year. This means not only that unemployment, which totalled 13.5% in December, may climb to 15%, but also that the number of bankruptcies will rise. Prospects are that Chile will not emerge from the present slump until early 1983. And even this forecast is dependent upon the assumption that the industrial economies will experience a recovery by the fourth quarter of 1982.

Philippine government reaffirms commitment to industrialization program.

The Philippine government remains steadfastly behind its ambitious industrialization program. The plan, which was drawn up in 1979, aims to reduce the country's dependence on labor-intensive industry through the construction by 1985 of eleven major projects, including: a copper smelter, a phosphatic fertilizer plant, an aluminum smelter, an integrated steel mill, and a petrochemical complex. Although several projects are underway, concerns have arisen over the availability of inputs and the attractiveness of final markets. Consequently, difficulties in lining up foreign investors have led to construction delays and several of the projects have been scaled back. Even the government admits that implementation of at least two of the projects—the aluminum smelter and the petrochemical complex—could be "difficult." Still, a recent study by the government's National Development Corporation estimates that if the projects are completed reasonably as planned, they could bring in close to $9 billion net in foreign exchange over the decade.

Singapore interest rates volatile, as monetary authorities grapple with policy dilemma.

Frequent monetary policy shifts have produced unusual interest-rate volatility in Singapore in recent months. Uneasy about persistently adverse international interest-rate differentials, the Monetary Authority of Singapore (MAS) in early March adopted a more restrictive money-market stance in an attempt to reverse a slowdown in the inflow of capital. As a result, domestic interest rates have risen in the past few weeks. Overnight rates, for example, climbed by more than 175 basis points to over 9% from about 7½%. This then created concerns, not only for the effects on imports of a stronger Singapore dollar against the yen and European currencies, but also over what might happen to domestic demand, which had been instrumental in maintaining Singapore's 10% rate of economic growth in 1981 in the midst of a stagnant world economy. In response to these concerns, the MAS has now apparently softened its policy stance and has intervened in the domestic money market in order to bring interest rates back down.

Nigeria faces huge current-account deficit.

During 1981, Nigeria's oil output shrank 30% to 1.44 million barrels per day, as world-wide demand for oil declined. Nigerian oil revenues fell some 28% and the current account of the balance of payments swung from a $2.9 billion surplus in 1980 to an estimated $8.5 billion deficit in 1981. Uncompetitive pricing caused record-low oil sales and unsustainable losses in the first quarter of 1982. This forced the Nigerians to enact a virtual ban on imports, soon to be replaced by specific import controls. In view of the continuing glut on world oil markets and Nigeria's urgent need for oil revenues—which normally account for some 95% of total export receipts—it is difficult to envisage how current Nigerian oil prices can be maintained. Even under optimistic output assumptions for the latter part of 1982, total oil revenues for the year are not likely to exceed $15 billion. And under less favorable conditions they could fall as low as $12.5 billion. Consequently, the current account of Nigeria's 1982 balance of payments could register a deficit in the range of $9-12 billion.

Signs of Hope For a Spring Recovery

As expected, the first official estimate of real Gross National Product released last week showed another contraction in U.S. economic activity during the first quarter of 1982. Real GNP fell at an annual rate of 3.9%, which was not much different from the 4.5% rate of decline reported for the last quarter of 1981. Along with other recent statistics, this strongly implies that the economic recession continued at least through March.

However, the GNP report included some good news, too. Final sales of goods and services actually increased. The recorded fall in overall real output was attributable to inventory reduction—a process that may soon be completed. Moreover, price inflation, as measured by the GNP deflator, dropped to an annual rate of 3.6%. Except for one quarter in 1976, that was the lowest rate in about a decade. The deflator increased over 9% last year. Although a portion of this apparent improvement was a purely statistical phenomenon, owing to a change in the mix of output, most of it represented real progress.

The current U.S. recession began last August. Initially, the slump reflected a decline in consumption and investment, which was largely the result of tight money and high interest rates. Declining sales created an inventory excess that had to be corrected. It is the degree to which this correction has been accomplished—while final sales have actually began to recover—that is encouraging. Inventories were being expanded at a rate of $27.5 billion in the third quarter of 1981; they were reduced at a rate of $40 billion in the first quarter of 1982—an exceptionally large swing of $67.5 billion at an annual rate.

A clear majority of economic analysts expect the U.S. economy to begin recovering this spring; the major progress that has been made in bringing inventories back in line with sales is the best evidence yet that they may be correct. A rise of 1.9% in new orders for durable goods, following an increase of 3.5% in February, was also a favorable sign. The principal remaining concern is that real interest rates may remain high enough to stifle an improvement in investment.

The recent drop in the U.S. inflation rate has exceeded the hopes of all but the most extreme optimists. Every broad measure of U.S. price trends has weakened. The Consumer Price Index increased at a rate of under 5% in December, under 4% in January, and under 3% in February. Producer (wholesale) prices declined fractionally in both February and March. Some of the improvement is temporary, to be sure: Commodity prices have declined because of widespread world-wide recession; they will recover when the world economy expands. And petroleum prices won't go down forever. But other prices have also eased. And there are signs of spreading moderation in the rate of increase in wage rates. Thus, the gloomy news of continuing economic decline should not be allowed to obscure the more hopeful signals of improvement.

Latin America Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1981		BALANCE OF				
		6 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	net c credit (loans of
Argentina	Economic uncertainty increases owing to Argentina-U.K. dispute.	Feb.	+ 9%	120.0	$4,263	Dec.	3,268	−51%	2.2	0
Barbados	Real GDP declines 1% in 1981 owing to downturn in tourism.	Sept.	−19%	0.9	3,644	Feb.	98	+28%	2.1	1
Brazil	Industrial activity at low levels; inflation rate slowly declining.	Dec.	+ 5%	284.8	2,307	Jan.	6,402	+16%	3.2	0
Chile	Recession intensifying as foreign credit inflows tighten.	Dec.	−19%	35.3	3,126	Feb.	2,982	− 5%	6.4	33
Colombia	Liberalized authorization allows companies to borrow funds from the international markets.	Sept.	−33%	37.3	1,399	Feb.	4,569	− 4%	10.1	3
Dominican Republic	Proposed Caribbean Basin Initiative will exempt 700,000 tons of sugar from U.S. tariffs annually.	Nov.	− 4%	7.3	1,314	Feb.	162	+10%	1.3	22
Ecuador	New multiple exchange rate system results in partial devaluation.	Dec.	0	13.8	1,676	Feb.	623	−22%	3.0	0
El Salvador	Substantial cotton and coffee production decline projected for 1982.	Aug.	−40%	3.3	666	Jan.	74	−39%	0.9	42
Honduras	Two new oil searches get underway in the southwest.	Oct.	0	2.9	762	Dec.	101	−33%	1.3	63
Jamaica	Bauxite production could fall to 8.5 million tons this year from 11.6 million in 1981.	Dec.	− 7%	3.1	1,360	Jan.	122	+ 1%	1.0	475
Mexico	Government approves additional wage increases of 10%-30%, despite business complaints.	Dec.	+25%	238.7	3,303	Dec.	3,972	+34%	2.4	0
Nicaragua	Foreign exchange certificates issued to stimulate exports—can be traded in parallel market.	Aug.	+54%	2.7	1,089	Sept. '79	87	+32%	1.1	23
Panama	Inflation rate falls to 5% owing to lower oil prices and reduced import costs.	Dec.	−32%	3.8	2,027	Jan.	104	+27%	1.0	90
Paraguay	Real GDP growth slowed to 8.5% during 1980-81 from 11.4% owing to export problems.	Dec.	−14%	5.4	1,664	Feb.	761	+ 2%	14.7	0
Peru	Agreement reached with IMF bodes favorably for improved demand management.	Dec.	−18%	21.0	1,160	Dec.	1,209	−39%	4.4	376
Puerto Rico	Decline of U.S. economy adversely affects island; unemployment reaches 22% high.	Nov.	+ 8%	11.7	3,688	Jan.	11,805	+20%	14.7	0
Uruguay	Economy is plunging into recession, as liquidity tightens and real interest rates rise.	June	+48%	10.9	3,711	July	403	− 5%	2.9	0
Venezuela	Government budget cut by $2 billion because of low oil revenues.	Dec.	+ 5%	69.4	4,494	Feb.	7,396	+ 5%	6.1	0

An Ill-Advised Proposal

The Federal Reserve is considering a change in the way it reports weekly money supply statistics. According to a recently announced proposal, which will not be voted upon for some weeks, the Federal Reserve would no longer report weekly averages of seasonally adjusted M1 numbers. Instead, it would release adjusted M1 figures as four-week moving averages, and report only unadjusted weekly average figures. The Federal Reserve is also considering releasing its money supply data later than the current 4:10 p.m. in the eastern time zone on Friday.

The Federal Reserve's consideration of these changes stems from concerns expressed by some Fed officials that the markets place too much emphasis on weekly money numbers. According to the Federal Reserve, publishing only the moving average of the weekly seasonally adjusted money data might be preferable in that "it would dilute the vast amount of 'noise' that is inherent in the individual weekly figure." It is widely recognized that the highly volatile weekly money numbers are poor indicators of the trend growth rate of M1, and that the method used to adjust the weekly M1 figures for seasonal variation is extremely imprecise.

The likely effect of this proposed change, however—if it is implemented—will be negligible. The Federal Reserve earlier this year released the weekly M1 seasonal adjustment factors it will use through the end of 1982. Thus, market participants will be able to compute the weekly seasonally adjusted figures from the raw data. And beyond 1982, Fed watchers will construct their own weekly seasonal factors.

More fundamentally, however, the apparent rationale for this proposed change is flawed. Market participants are not irrational in their reactions to weekly money numbers; rather, their response is consistent with the current operating strategy of the Federal Reserve. The behavior of the money supply has a major impact on the open market activities of the Fed, and, through these operations, on the federal funds rate. When a given weekly money number differs significantly from the markets' expectations, there is no sure way of telling how much of this change will be immediately reversed. Consequently, weekly changes in M1 affect the markets' best guess of the current month's M1 growth rate. And since experience indicates that monthly deviations of money growth from the Fed's targets often lead to changes in its reserves targets, weekly M1 figures affect expectations of the future level of the federal funds rate.

Rather than altering its money reporting procedures, perhaps the Federal Reserve would be better advised to release more information on its operating targets and policy intentions. The Federal Reserve's current short-run targets for various measures of bank reserves and the monetary aggregates, as well as for the trading range of the federal funds rate, are unknown. The timely reporting of these targets would better facilitate the market's difficult task of deciphering the current policy intentions of the Federal Reserve.

PAYMENTS		MONEY AND BANKING							COUNTRIES
		12-month changes			exchange rate in U.S. dollars	change from year earlier			
f IMF , mil- dollars	current influences on payments	latest data	consumer prices	latest data	money supply(M1)	April 21, 1982		current monetary conditions	
	Foreign exchange made available to pay non-U.K. obligations.	Feb.	+149%	Dec. '80	+95%	.000082	−80%	Liquidity eases with lower reserve requirement.	Argentina
	Consumer imports restricted.	Dec.	+ 12%	Dec.	+ 5%	.5200	0	Savings rate increased.	Barbados
	Lower oil import costs help produce trade surplus.	Jan.	+ 98%	Aug.	+58%	.0068	−50%	Ceilings placed on bank credit growth.	Brazil
	Huge narrowing of 1982 current-account deficit expected as demand contracts.	Feb.	+ 7%	Sept.	+17%	.0270	+ 5%	High real interest rates continue.	Chile
	Prior import deposits cut to 20% from 39%.	Dec.	+ 26%	July	+28%	.0210	+11%	Monetary Board provides more liquidity.	Colombia
	Foreign banks reach accord with central bank on commercial arrears.	Sept.	+ 8%	Dec.	+ 7%	Par	—	Monetary policy is restrictive.	Dominican Republic
	Oil exports decline in early 1982.	Dec.	+ 18%	Oct.	+23%	.0240	−36%	Money supply is severely restricted.	Ecuador
	Net international reserves were minus $260 million at end of 1981.	Dec.	+ 12%	Nov.	+ 7%	.4000	0	Interest rates raised to stem capital flight.	El Salvador
	IMF approves $27 million credit to cover drop in coffee and banana exports.	Nov.	+ 10%	Dec.	− 1%	.5000	0	Deposits down 10% in 1981.	Honduras
	U.S. agrees to buy 1.6 million tons of bauxite for its strategic stockpile.	Dec.	+ 5%	Nov.	−16%	.5700	0	Monetary stance remains restrictive.	Jamaica
	Mexican travel abroad declines after devaluation.	Jan.	+ 31%	Nov.	+40%	.0220	−47%	Central bank attempts to reduce interest rates.	Mexico
	Levy on non-traditional exports raised to help meet debt-servicing needs.	July	+ 28%	July	+38%	1.4930	n. a.	Net foreign assets falling.	Nicaragua
	Canal tolls to be raised almost 10%.	Jan.	+ 5%	Dec.	+10%	Par	—	Domestic loan growth is strong.	Panama
	Exchange rate devalued for certain exports.	Sept.	+ 10%	Oct.	+ 8%	.00795	− 1%	Money-supply growth restricted.	Paraguay
	Toquepala mine expansion delayed.	Oct.	+ 73%	Sept.	+41%	.00169	−35%	Zero credit growth to public sector expected.	Peru
	Tourist spending below normal.	Jan.	+ 7%	Jan.	+14%	Par	—	Decline in private savings accounts.	Puerto Rico
	Import restrictions being tightened; 1985 average tariff duty will be over 35%.	Aug.	+ 33%	Dec.	+ 7%	.0890	−10%	Deposit rates lowered to 40%-43%.	Uruguay
	Oil production to be cut to 1.5 mbd, lowering exports to 1.1 mbd.	Dec.	+ 11%	Oct.	+ 7%	.2330	0	Foreign reserves down $800 million since December.	Venezuela

World Interest Rates

market rates as of April 21, 1982; bond yields as of April 16, 1982

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	12.00	15.34	12.979 intervention rate	14.00	9.50	7.50	19.00 penalty rate 22.00	8.00	5.50	5.50
Day-to-Day Money	14.75 April 22	15.50	13.00	13.50	16.50	9.45	20.375	7.50	3.25* 1-month Euro-Swiss fr. rate	7.125
Treasury Bills 91-day, Middle Rates	12.22 discount basis	14.95	13.00	15.00	n. a.	n. a.	17.90 70 days	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	13.50 finance paper discount basis	15.45 finance paper 15% tax w/h	12.233	13.90 Certified	16.375 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	13.75	15.50 15% tax w/h	12.9375	13.90 Certified	not traded	9.40	21.60	no market	5.125	no market
Government Bonds Long-term, new and old issues, average yield	13.48	15.375	13.87	10.80 20% tax w/h	16.065	8.98	20.35	10.21	5.07	7.29
Industrial Bonds prime, long-term, new and old issues, average yield	14.85 Aa Industrials	15.75	15.02	15.51	17.06	8.97	20.42	11.22	6.01	6.57
Bank Short-Term Rate to Best Borrowers (prime rate)	16.50	17.00	14.00	17.50	18.50	13.00	21.75 ⅛ qtrly fee on outstdng.	11.00	9.50	6.00
Bank Time Deposits 3-month	14.00 Cert. of Dep.	14.3125	13.6875	14.65	16.25	9.05	11.50	8.125 large deposits	4.75 residents only	3.75 20% tax w/h
Eurocurrencies 3-month, asked	15.00	15.625	13.8125	no market	23.25	8.9375	no market	8.0625	5.00	6.875
Exchange Rates—in U.S.$ rates floating against the $	—	.8175	1.7790	.022	.1605	.4178	.000759	.3770	.5105	.004127
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	.587 *D*	1.468 *P*	2.945 *D*	7.995 *D*	6.030 *P*	8.443 *D*	6.897 *P*	10.064 *P*	8.058 *P*

Eurodollar Deposits
(London, interbank, bid)
April 22

7-day	14.8125
1-month	14.875
3-month	14.875
6-month	14.875

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−2.068
U.S.-Canada Treasury Bills	−1.433
U.S.-Canada Finance Co. Paper	−1.151
Eurodollars-U.K. Local Auth. Deposits	− .030

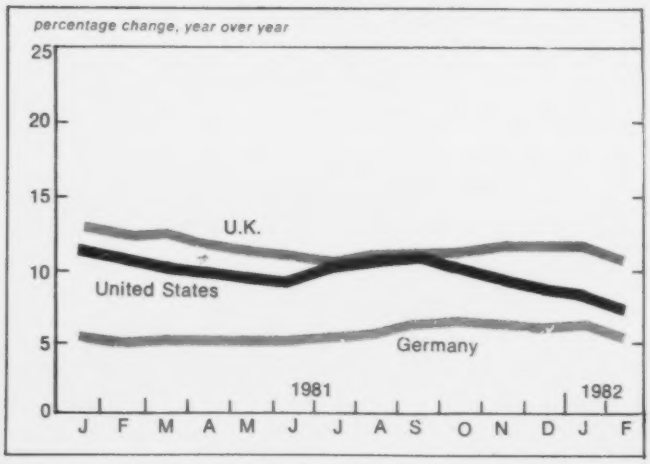
Eurobonds
(average yield on recent straight debt issues)

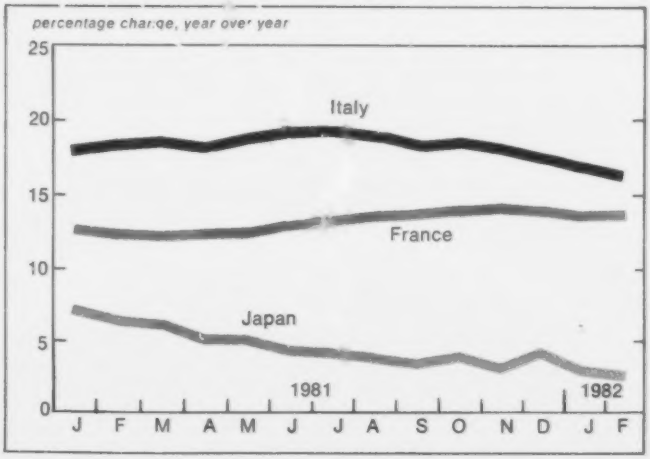
U.S. Dollar Bonds	
7 yrs. and under	14.375*
Over 7 yrs.	14.625*
DM Bonds	
7 yrs. and under	9.00*
Over 7 yrs.	9.25*

Gold Price
London afternoon fixing
344.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.
*Market rates as of April 14, 1982.

Consumer price trends in major industrial countries





Bermuda: International Business Lends Support

Bermuda—a scenic and sunny archipelago, set in the Western Atlantic about 600 miles off the eastern coast of the United States—is a place where thousands of tourists come each year to forget their troubles. In the years when the vacationers do not come, however, this resort colony has a few economic troubles of its own. Last year was one of those years.

Buffeted by domestic labor strikes, world recession, and sharp increases in hotel costs and airfares, Bermudas' tourism industry suffered one of its worst years in recent history. And for the time being, the tourism slump has stalled the rapid economic growth enjoyed by Bermuda in recent years. Nevertheless, the economy as a whole is far better equipped to weather the current slowdown than in previous years, owing to a substantial buildup in the islands' international business sector.

As a high-income, tourism-based British colony, Bermuda has undergone exceptional economic growth over the last half-decade. Since 1976, GDP has doubled in current dollar terms, reaching $725 million in 1981. With a population of about 55,000, this amounts to an annual per capita income of over $13,000. Bermuda's agricultural and industrial sectors are small, and the bulk of its income—some 85%—comes from tourism and international business.

Tourism, by far, remains the predominant industry in that it brings in about 60% of the colony's annual foreign exchange earnings and employs about three-fourths of the work force. As a result, fluctuations in the tourist trade have produced variations in real GDP during the past few years. But the increased presence of the international companies has helped to temper the impact of the downswings in visitors. Real growth in fiscal year 1979-80 measured 6.5%, as tourist income increased strongly. With the slowdown in tourism revenues begining in 1980-81, however, economic growth decelerated to 4.8%. Official statistics for the just-ended fiscal year 1981-82 are not yet available, but indications are that real GDP registered a modest decline.

Tourism down sharply

Bermuda's tourism sector has undergone a severe contraction over the last year, falling to its lowest level since 1975. Overall tourist arrivals shrank by about 12% in 1981. The volume of visitors from the United States, which comprises about 88% of the total number of tourists annually, was off by a similar amount. And vacationing visitors from Canada, Great Britain, and other European countries fell far short of their 1980 levels. Thus far in 1982, the tourism slowdown has shown no improvement. Through February, the number of visitors was some 28% below the already depressed level for the comparable period in 1981.

To some extent, Bermuda's downturn in tourism reflected the recession in the United States and other parts of the world. But the unusual severity of the decline was more the result of domestic economic events. In May of 1981, Bermudan hotel employees and taxi drivers went out on strike in a demonstration of sympathy with striking government blue-collar workers. The strike lasted four weeks and forced the closing of all but one of the islands' ten largest hotels. Coming as it did during tourism's "high season," the strike resulted in a 90% drop in the number of tourists usually expected during this period. For the Bermudan economy, this meant a loss of some $30 million, or nearly 5% of national income. By the time the strike was settled, tourism had been seriously affected. And because the labor difficulties came at a time of economic recession in the United States, future visitor bookings were depressed even further.

The overall economic impact of reduction in Bermuda's tourist earnings during 1981 was partially offset by the activities of international business and services companies. Attracted by favorable tax arrangements, good communications, and strong support services, international firms located in the islands in 1981 totaled some 5,000—a 25% increase from just three years earlier. The operations of these firms—known as "exempt" companies—are outside of Bermuda. They cover a range of international activities, but the so-called "captive" insurance and reinsurance companies are the dominant exempt group. These are the insurance subsidiaries of leading multinational corporations, most of them U.S.-owned. In addition to insurance firms, Bermuda's international businesses include principally shipping and private trust companies. As a sector, international business contributes about one-fourth of the colony's foreign exchange earnings and approximately the same share of GDP.

The outlook

The prospects for an economic revival in Bermuda in the current fiscal year 1982-83 will depend on the recovery of income growth in the U.S. and Canadian economies, as well as on specific tourist industry influences such as hotel rates, room capacity, and airfares. The country's rate of inflation has moderated substantially—down to an annual rate of 9.4% in February from a peak of 15% in February 1980. This should help to ease any local cost pressures. But with annual imports equal to two-thirds of GDP, any further improvement in the Bermudan price level will be dependent upon changes in inflation in other parts of the world. Nevertheless, with the activities of the international companies holding steady, the resort economy should regain its momentum once U.S. and world economic conditions improve.

A. Blake Friscia

Managing Interest-Rate Risk

The recent volatility and unpredictability of U.S. interest rates have made corporations increasingly sensitive to the costs associated with interest-rate risk. Many firms have initiated short-run financial management programs to reduce the perceived risks, and many more firms are contemplating complex short-run hedging strategies using financial futures, as well as traditional asset and liability exposure management techniques.

Such short-run interest-rate risk management programs raise several critical corporate issues. The first is the question of whether interest-rate risk is really interest-rate risk. In the short-run, probably yes, but in the long-run interest-rate risk begins to mirror inflation risk. This leads to a second consideration, that of short-run versus long-run financial strategies. If long-run inflation exposure is best hedged with floating-rate debt, as much research suggests, then a short-run hedging program may be counter-productive. That is, firms may simply be trading short-run risks for different long-run risks. With this in mind, a third point arises concerning which risks the firm's stockholders would prefer to have managed. The answer is not always clear. For many firms, short-run interest-rate hedging programs are clearly essential to long-run survival, but for others this is less the case. A well-structured financial risk management strategy needs to recognize these points explicitly.

Interest-rate and inflation risk

A necessary first step in analyzing financial risk is to distinguish between the long-run and short-run relationships among interest rates, inflation, and the dynamics of financial markets. Over the long run, expected inflation is the principle determinant of nominal interest rates, as can be easily seen from the following table comparing the low interest rates and low inflation rates of the 1950s and 1960s with the higher inflation and interest rates of the 1970s.

The long-run inflation/interest-rate relationship
(percent, annual averages)

	1951-60	1961-70	1971-80
Inflation rate (CPI)	1.4	3.0	10.4
U.S. Treasury bond yields	3.2	4.9	8.0

Investors generally seek an adjustment, or premium, for anticipated inflation in the nominal returns they receive, so these variables will move together over extended periods. Thus, over the long run, interest-rate risk reduces to a more fundamental "inflation risk."

In the short run, inflation expectations have less meaning as a guide for investors seeking to preserve their real rates of return. Rather, movements in interest rates become dominated by changes in monetary and fiscal policies—and by expectations as to those policies—through the dynamics of financial markets, well before the effects of these policy changes are felt in the price level. Over this short run—which may comprise weeks, months, or even years, if the policy change is dramatic and the adjustments required are large—interest-rate risk may be appropriately distinguished from inflation risk.

A corporate perspective

A corporate financial risk-management strategy, for both the short run and the long run, should be formulated in the context of these separate inflation and interest-rate risks. It may be possible, for example, to build a natural long-run hedge against inflation risk into the debt structure of a corporation with the use of floating-rate debt. If a firm's earnings tend to keep pace with inflation, then in the long run the firm's gains from inflation on the earnings side will offset higher interest expenses. Such a firm may wish to use floating-rate debt for this feature, which produces a long-run trade-off between interest rates and inflation. This is in contrast to fixed-rate debt, which is essentially a bet against inflation rather than a hedge against its fluctuation.

Of course, the firm's ability to manage long-run inflation risk in this manner requires that it be able to weather substantial financial disturbances in the short-run. To determine whether it is sufficiently robust, the firm must assess its short-run interest-rate risk relative to its capital base, business plan, and anticipated cashflows. The firm must consider a variety of possible interest-rate scenarios and the probabilities associated with each. Then the firm is in a position to evaluate the implications for its bottom line in each case.

Essentially, there is no point in managing interest-rate risk unless the firm is vulnerable in the short run. In addition, it should be noted that hedging short-run interest-rate risk may mean that the firm will not benefit from any long-run offsets between interest rates and inflation. That is, if floating-rate debt is hedged in the short-run for interest-rate risk management purposes, then the benefits of the floating-rate debt and inflation trade-off may be missed, since turning points in interest rates are notoriously difficult to call. Thus, it is critical for the opportunity costs of short-run management to be fully recognized in a long-run perspective. From a stockholder's point of view, short-run interest-rate risk management may be more costly than it appears month to month to the business manager, if long-run issues are ignored.

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